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EARNINGS MANAGEMENT AND INSTITUTIONAL DIFFERENCES : LITERATURE REVIEW AND DISCUSSION

by

**H. VANDER BAUWHEDE
M. WILLEKENS**



Katholieke Universiteit Leuven

Naamsestraat 69, B-3000 Leuven

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Heidi Vander Bauwhede

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Abstract

This paper provides a review of the empirical earnings management literature. In particular, it presents a review of the factors that induce and constrain earnings management through accounting decisions. The consequences of actual or assumed earnings management are also discussed. The far majority of the literature focuses on the Anglo-Saxon context. However, major differences exist between Anglo-Saxon and continental European countries. This may result in differences in the importance of various incentives of and constraints on earnings management. In particular, we argue that explicit contracts and a firm's relations with capital markets may be less important sources of earnings management in continental Europe. Implicit contracts and the political and regulatory process may however be of major importance. We question further whether a firm's ownership and internal governance structure and the quality of the external auditor can constrain the ability to manage earnings in continental European countries.

Earnings management and Institutional Differences:

Literature review and discussion

Heidi Vander Bauwhede¹

Marleen Willekens²

1. Introduction

This paper provides (1) a review of the empirical earnings management literature, (2) a discussion of the institutional differences between Anglo-Saxon and continental European countries and (3) an assessment of the impact of institutional differences on earnings management.

As (accounting) earnings can be considered an important summary statistic of a firm's financial performance, one can question whether managers do not "manage" those earnings. It is clear that financial, investment and operational decisions can influence earnings. However, accounting decisions too can be used to manage earnings in a particular direction, for GAAP leave some discretion to managers in reporting the financial position, operating results and cash flow of their organization. Examples of accounting decisions that can influence earnings are accrual decisions, accounting procedure choices and changes, timing of adoption of a mandated accounting change, and the like.

Earnings management has been researched in the literature both analytically and empirically. Analytical models (see, for example, Lambert 1984, Demksi et al. 1984, Verrecchia 1986, Dye 1988, Trueman & Titman 1988, Fudenberg & Tirole 1995, Evans &

¹ PhD student, Department of Applied Economics, Catholic University Leuven, Naamsestraat 69, 3000 Leuven, Belgium. E-mail: Heidi.Vanderbauwhede@econ.kuleuven.ac.be; tel. +32 16 32 69 30).

² Associate professor, Department of Applied Economics, Catholic University Leuven, Naamsestraat 69, 3000 Leuven, Belgium. E-mail: Marleen.Willekens@econ.kuleuven.ac.be; tel. +32 16 32 69 32).

Sridhar 1996) study conditions under which earnings management can occur, whereas empirical studies document instances of earnings management (Schipper 1989). In this paper, we limit ourselves to a review of the empirical earnings management literature.

The review provides some evidence that managers have incentives to manage earnings, that they do actually engage in earnings management and that there are factors that constrain their ability to manage earnings. Some studies report also on the consequences of actual or assumed earnings management. Most empirical studies were performed in Anglo-Saxon countries. Since there exist institutional differences between Anglo-Saxon and continental European countries, we argue that the factors that create incentives and constraints on earnings management may be different for these environments, and some results of Anglo-Saxon studies may not hold in continental European countries.

The remainder of the paper is organized as follows. The second section presents a literature review. The third section discusses the institutional differences between Anglo-Saxon and continental European countries. An assessment of their viable impact on factors that create incentives and constraints on earnings management is provided in section four. We conclude with a summary.

2. Literature review

Empirical studies mainly report on the incentives to manage earnings. Some recent empirical studies also examine factors that might constrain earnings management. The following paragraphs give an overview of (1) the incentives to manage earnings, (2) the factors that might constrain and (3) the consequences of earnings management.

A first category of incentives examined stems from the contracting literature. In the early literature it is often argued that earnings management is induced by the existence of *explicit* contracts, for example bonus plans and debt covenants. The recent literature, however, also focuses on *implicit* contracts, as a source of earnings management incentives. The main concern that “drives” these studies, is that, although the flexibility provided by

GAAP can improve efficient contracting, managers might use this flexibility to act opportunistically.

A first well established hypothesis in the empirical financial accounting literature is that *bonus plans* based on accounting earnings might induce managers to manage (manipulate) earnings through their accounting procedure and accrual decisions, in order to increase their cash compensation. More specifically, early studies test the *bonus plan hypothesis*, which states that “Ceteris paribus, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period” (Watts and Zimmerman 1986, p.208). Later studies examined related and more refined hypotheses using different measures of earnings management and using other datasets. Examples of studies on the bonus plan hypothesis include Healy (1985), McNichols and Wilson (1988), Gaver et al. (1995), Holthausen et al. (1995) and Dechow et al. (1996). Although the early literature finds evidence that is generally consistent with the bonus plan hypothesis (Watts and Zimmerman 1990, p.138), more recent studies document mixed results (that is, results differ when other datasets and measures of earning management are used). This comes as no surprise, as Watts and Zimmerman (1990, p.139) argue that the early tests are not very powerful, because they rely on simplifications of the (contracting) theory.

Another well established hypothesis in the contracting literature is that the (1) existence of and/or (2) closeness to *debt covenants* might induce managers to manipulate accounting earnings. Early empirical studies that test *the covenant based hypothesis* use leverage as a proxy for (1) the existence of and/ or (2) closeness to debt covenants. In fact, they test what is called *the debt/equity hypothesis*. More specifically, it is hypothesized that “Ceteris paribus, the larger a firm’s debt/equity ratio, the more likely the firm’s manager is to select accounting procedures that shift reported earnings from future periods to the current period.” (Watts and Zimmerman 1986, p.216). Later studies provide “direct” evidence of the covenant based hypothesis. DeFond and Jiambalvo (1994) and Sweeney (1994), for example, contribute to the literature because they do not use a proxy, but base their study of the

covenant based hypothesis on a sample of firms that actually reported to have violated debt covenants. Other studies include: Dechow et al. (1996) and DeAngelo (1994). Except for the DeAngelo (1994) study, both the early accounting choice studies, which use proxies, and more recent research, which circumvents the use of such proxies, document (in general) evidence consistent with the covenant based hypothesis.

The above evidence suggests that *explicit* contracts have an impact on earnings management through accounting decisions. Bowen et al. (1995) and Kasanen et al. (1996) examine whether *implicit* contracts (that is, for example, implicit contracts between the firm and its customers, suppliers, short-term creditors, employees, capital providers and other stakeholders) do also influence managers' accounting decisions. Both studies find evidence which is consistent with implicit contracts inducing earnings management. Moreover, Bowen et al. (1995) find that implicit contracts can explain cross-sectional variance in firms' accounting procedure choices in addition to traditional variables, for example, the proxies for the explicit contracts mentioned above, that is bonus plans and debt covenants. However, the literature on implicit contracting incentives is rather new and limited, and so it seems too early to draw general conclusions.

The *contracting perspective* is not the only way to look at management's accounting decisions. An alternative is to address those decisions from a *capital market perspective* (see, for example, Healy and Palepu 1993). In general, research findings provide empirical evidence that a firm's relation with capital markets can create incentives to influence earnings. Some of those studies expect firms to manage earnings opportunistically (Shivakumar 1998, Dechow et al. 1996, Rangan 1998 and Teoh et al. 1998). Other studies consider that earnings may be managed in order to communicate private information to investors (Subramanyam 1996, Neill et al. 1995). Subramanyam (1996), for example, finds supportive evidence of the hypothesis that managers use discretionary accruals to communicate information about future profitability, that is the economic value of the firm. Also the findings of Neill et al. (1995) suggest that accounting method choice can signal firm

value. Dechow et al. (1996) test whether managers manipulate earnings to influence investor's perception of firm value in order to be able (1) to raise additional financing on more favorable terms or (2) to sell their stockholdings for a higher price. They find that the need for external financing seems to be an important motive to explain managers engaging in earnings manipulation, whereas insider trading seems to be less important. Some recent studies find that earnings are managed prior to or around initial public offerings (Friedlan 1994, Aharony et al. 1993, Neill et al. 1995) or seasoned equity offerings (Shivakumar 1998, Rangan 1998, Teoh et al. 1998).

The political and regulatory process through, for example, taxes, rate regulation and investigations by regulatory agencies may also create incentives to manage earnings (see, for example, Watts and Zimmerman 1986). A hypothesis often tested in accounting choice studies is the *political cost hypothesis/ size hypothesis*, which states that "Ceteris paribus, the larger the firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods" (Watts and Zimmerman 1986, p.235). Note that formulating the impact of the hypothesized impact of the political and regulatory process this way, assumes that larger firms are more political sensitive than smaller firms. Recent research on the impact of the political and regulatory process on earnings management includes Jones (1991), Guenther (1994), Bowen et al. (1995), Hunt et al. (1996), Key (1997) and Han and Wang (1998). In general, one can conclude that prior research provides evidence consistent with earnings management induced by the political or regulatory processes.

There exist also some studies that examine whether specific circumstances induce earnings management. Liberty and Zimmerman (1986), for example, study the impact of labor union contract negotiations on managers' accounting decisions, but do, however, not find evidence of earnings management. And DeAngelo (1988) examined whether proxy contests create incentives for managers to influence earnings and finds evidence consistent with this hypothesis. In particular, it seems that, during the election campaign, managers use their accounting discretion to create a favorable picture of their performance.

Finally, a recent study (Burgstahler and Dichev 1997) find evidence consistent with the hypothesis that earnings are managed to avoid earnings decreases and losses.

Some studies examine a specific type of earnings management, i.e. income smoothing. The hypothesis is that managers might manage earnings to reduce the variability of reported earnings or to align reported earnings with expected earnings. Explanations for income smoothing include job protection and avoidance of shareholder interference, tax avoidance, improving terms of trade and pursuing a fixed dividend pay-out ratio. Studies include Eckel (1981), McNichols and Wilson (1988), Hunt et al. (1996), Subramanyam (1996), DeFond and Park (1997), Young (1998). The evidence on the income smoothing hypothesis is however mixed.

From the above review it is clear that until now empirical research has mainly focused on the *incentives* to manage earnings. Recent research also examines *factors that might constrain* earnings management. These include prior accounting decisions, ownership structure, strength of the internal controls, internal governance (especially the existence of an audit committee and some characteristics of the board of directors, such as, for example, board size, board composition and separation of the functions of Chairman of the Board of Directors and Chief Executive Officer) and quality of the external audit.

The impact of prior accounting decisions on earnings management was studied by DeFond and Jiambalvo (1991). They found that earnings “manipulation” is more likely in firms where the remaining number of income-increasing GAAP possibilities is smaller. Moreover, Sweeney (1994), argues that the accounting flexibility available to managers, which is influenced by their prior accounting decisions, is an important determinant of managers’ accounting responses to debt covenant violation.

The impact of ownership structure on earnings management was examined by DeFond and Jiambalvo (1991), Warfield et al. (1995) and Rajgopal and Venkatachalam (1998). Research results suggest a negative relation between (1) managerial ownership (Warfield et al. 1995) or institutional ownership (Rajgopal and Venkatachalam 1998) and (2)

the magnitude of accounting accrual adjustments (=a measure for the extent of earnings management). Earnings “manipulation” was, however, found more likely in firms with diffuse ownership (DeFond and Jiambalvo 1991).

Further, results indicate that earnings overstatements are less likely in firms that have an audit committee (DeFond and Jiambalvo 1991). However, no evidence was found that stronger internal controls reduce the likelihood of earnings overstatement (DeFond and Jiambalvo 1991).

Studies on the impact of the characteristics of the board of directors on earnings management (Dechow et al. 1996, Peasnell et al. 1998 and Beasley et al. 1996) find that at least some of those characteristics are related to earnings management.

Further, several studies examine whether a higher quality audit constrains (opportunistic) earnings management more than a lower quality audit. The impact of audit quality on both GAAP as well as non-GAAP earnings management was tested. Evidence was found of a relation between audit quality and earnings management within GAAP. In particular, Becker et al. (1998) found that discretionary accruals for clients of non-big6 auditors are higher than for clients of big6 auditors. Francis et al. (1997) found that the amounts of discretionary accruals of big6 client firms are lower than those of non-big6 client firms. The evidence on the relation between audit quality and non-GAAP earnings management is, however, mixed. Dechow et al. (1996), do not find that the use of a Big6 auditor differs between firms that were subject to enforcement actions by the SEC (that is, firms that are “suspected” to have engaged in non-GAAP earnings management) and the control firms. Higher audit quality was, however, found to reduce the likelihood of errors and irregularities (DeFond and Jiambalvo 1991) and to increase the likelihood of auditor-client disagreements over income-increasing accounting methods (DeFond and Jiambalvo 1993). Finally, Shivakumar (1998) finds some evidence which, he argues, is consistent with auditors limiting managerial discretion over accounting procedures.

Some studies do not only examine the factors that *induce* or *constrain* earnings management, but study also the *consequences* of actual or assumed earnings management (Shivakumar 1998, Dechow et al. 1996, Rangan 1998 and Teoh et al. 1998, Neill et al. 1995). This research is, at the moment, limited to the consequences of earnings management induced by a firm's relation with capital markets. In particular they document whether firms (or firm managers) succeed in their attempt to influence their relations with a specific stakeholder, i.e. investors. They provide also some evidence on the long run consequences of earnings management.

Shivakumar (1998), for example, finds that, when firms manage earnings prior to an equity offering, investors already recognize this at the equity offering announcement date, which suggests that investors cannot be “fooled” by managing earnings. He finds also a decrease in the stock price response to subsequent earnings announcements, which he attributes to earnings management. Shivakumar (1998), Dechow et al. (1996), Rangan (1998) and Teoh et al. (1998) find, however, that firms managing earnings do initially succeed in their attempt to influence investors' perception of firm value. Dechow et al. (1996) find that when earnings management is revealed, increases in the costs of capital follow. Rangan (1998) and Teoh et al. (1998) find that the poor (stock and income) performance of seasoned equity offerings in the post-offering announcement period, can be explained by earnings management around or prior to the equity offering. Neill et al. (1995) find that both offering values and underpricing related to accounting method choice. He suggests that this is not the result of opportunistic earnings management, but of accounting method choice being a credible signal to investors of firm value.

3. Institutional differences between Anglo-Saxon and continental European countries

From our review of the literature (Flower 1997, Ball 1997, Joos and Lang 1994, FEE 1997, Paisey 1991 and Nobes 1984) it is clear that there exist institutional differences between countries along various dimensions. Those are, for example, differences in legal systems, in providers of finance (in particular, the importance of capital markets), in ownership and corporate governance and in the link between tax and accounting (see, for example, Nobes 1984). Such factors may cause the various international differences that can be observed in accounting (Nobes 1984, p.3). Differences at the accounting level are, for example, a different source of demand for accounting (that is, different goals for financial reporting and different key users of financial statements), different conceptual frameworks (FEE, 1997) and accounting systems, different sources of accounting rules and degree of detail in which they are specified. It seems a logical consequence that those differences will, in turn, have an impact on the ability and the incentives to manage earnings.

In the literature on institutional and accounting differences between countries one often classifies countries as either 'Anglo-Saxon' or 'continental European'. We note however that such a typology is rudimentary for the following reasons. Some countries on the European continent have characteristics of Anglo-Saxon countries along some dimensions. There also exist differences between countries belonging to one category or the other, especially between continental European countries. And finally, given the creation of a European internal market (and the creation of a European capital market in particular) and the globalization of the economy in general, various institutional differences are diminishing. In the subsequent paragraphs we briefly discuss various institutional and related accounting dimensions along which countries differ and which we identified from our review of the literature. We hereby use the typology 'Anglo-Saxon' versus 'continental European', however bearing the above reservations in mind.

With respect to the legal system, Anglo-Saxon countries are characterized by a common law system, whereas continental European countries are mostly operating under codified law systems. In common law systems there is only a limited amount of statute law as only general principles are enacted by the legislator (Flower 1997, pp.38-39). The courts then interpret those principles and build up a body of case law. In continental European countries, however, the legal system is based on Roman Law, which specifies rules in great detail (“codified law systems”). The main role of courts in those systems is to enforce the law.

The major differences in ownership and providers of finance can be summarized as follows. In Anglo-Saxon countries, capital markets are in general well developed, the majority of companies is listed on the stock exchange and shares are held by a vast number of individual shareholders (widespread ownership). In continental European countries, however, capital markets are less developed. Only a minority of companies is listed on the stock exchange and funds are mainly provided by, for example, banks (this is the case, for example, in Germany) and other financial institutions, the state (for example, in France), family members or business contacts. Even when firms are listed on the stock exchange, ownership is still concentrated (that is, there are few shareholders).

The above differences in legal systems, providers of finance and ownership have several implications on the accounting level. In particular, the differences in ownership structures have an impact on the demand for accounting information and the users of financial statements. The fact that in Anglo-Saxon countries funds are obtained from a vast number of individual shareholders raised through the capital market makes that the financial statements are an important means to communicate information to shareholders and that shareholders are the main users of the financial information. Companies are also willing to provide this information to enhance their ability to raise additional funds through the capital market. By contrast, in continental European countries, external providers of finance such as, for example, bankers have closer relations to the company (they require, for example, a seat on the board of directors), and obtain the information they need through direct contacts and

internal financial reports, rather than through published financial information, i.e. the financial statements³. In those continental European countries, the demand for financial information stems mainly from the government, who needed that information in order to plan and control the economy or to raise taxes. As companies were less motivated to make accounting information public, governments had to oblige firms to do so (Flower 1997, p.41).

Differences in ownership structure and related differences in major users of financial statements parallel differences in goals of financial reporting. In the UK and US, the dominant objective of financial statements is to provide information to capital markets. In continental Europe where third party protection (e.g. creditor protection) is paramount and demand stems from government, both prudent assessment of distributable profit (to protect third parties) and tax assessment (for government) have traditionally been important objectives of financial reporting. Although the Fourth Directive⁴ states that ensuring a good level of information is an objective of financial reporting, it *also* suggests that prudent assessment of distributable profit is an important objective. Further, the link between financial reporting and tax continues to exist, although the fourth Directive (FEE 1997) provided the possibility to separate taxation and accounting⁵. These issues may raise concerns about the role of financial statements in providing information in continental European countries.

Differences in objectives of financial reporting result in different accounting frameworks, that is, “the fundamental concepts which lie behind the accounting law or regulation” (FEE 1997, p.3). The FEE (1997, p.8) reports that, in Anglo-Saxon countries the

³ Consequently, it seems that in continental European countries financial reporting is a less important element in the system of corporate governance of a business. In fact, there are also differences in systems of corporate governance. In continental European countries, providers of finance (and other stakeholders to the company) are more directly involved in corporate governance, while in Anglo-Saxon countries, corporate governance relies more on external board members and on monitoring by external providers of debt and equity capital (Ball 1997, p. 8).

⁴ The fourth council Directive on the annual accounts of limited liability companies. The philosophy of this Directive was to require companies to prepare annual financial statements complying with basic accounting principles and disclosure requirements (FEE 1997, p.3).

⁵ Note, however, that tax is more generally linked to individual financial statements (FEE 1997, p.13). And a difference can be observed between consolidated accounts and individual accounts. The former (i.e. consolidated financial statements) are more aimed to provide information (FEE 1997, p.9)

most important principles seem to be the substance over form and the matching principles. In those continental European countries where creditor protection is considered a particular important objective of financial reporting (like, for example, in Germany), special attention is given to a conservative application of the prudence and historical cost principles. In those continental European countries where tax assessment seems to be an important objective of financial reporting, it is difficult to identify any dominant concepts.

Finally, differences in legal systems as well as different users of financial statements are related to different sources of accounting rules and the degree of detail in which they are specified. Nobes (1984, p.16) reports that in continental European countries accounting rules are mainly to be found in company laws, commercial codes and tax regulations, that is, accounting rules are law-based (law-based accountancy). Those codes usually also specify detailed rules for accounting and financial reporting. In Anglo-Saxon countries, however, it is the accounting profession itself which effectively governs accounting practice, which resulted in detailed accounting standards (profession-based accountancy). Those standard still permit considerable flexibility and the use of judgement. Under common law systems only general principles are enacted, and company law does not prescribe detailed rules on how companies should publish their financial statements.

4. Discussion of the impact of institutional differences on incentives for, opportunities of and constraints on earnings management

In section 2 we gave an overview of (Anglo-Saxon) research findings on incentives for, constraints on and consequences of earnings management. Given that there exist institutional and hence accounting differences between Anglo-Saxon and continental European countries, we expect that the importance of alternative incentives for earnings management investigated in the Anglo-Saxon literature may be different within a continental European setting. We also expect this to be the case for factors that constrain earnings management. In order to examine earnings management in continental Europe, it is important

to assess first in general which incentives and constraints may be different in such a continental European setting.

Our views with respect to incentives for earnings management are the following. First, we believe that earnings management induced by explicit contracts might be less important in a continental European setting. The reason for this is the following. Widespread ownership in Anglo-Saxon countries result in more pronounced problems with respect to conflict of interest and information asymmetry as compared to continental European countries⁶ where ownership is concentrated. With concentrated ownership explicit contracts (such as bonus plans and debt covenants) which fulfill the role of alleviating agency costs which parallel the conflict of interest problem are less effective.

Second, we believe that the incentives to manage earnings created by capital markets (in particular, earnings management in order to communicate private information to investors, or earnings management in view of raising new funds on capital markets at more favorable terms) do not apply for the majority of companies in those countries. The reason is that only a minority of firms are listed on the stock exchange in continental European countries.

Third, we believe incentives to manage earnings created by the political and regulatory process to be especially important in those continental European countries where the demand for disclosure of financial information stems mainly from the government and where there is a pronounced link between financial and tax reporting (see, for example, also the fact that regulation cannot only be found in company laws and commercial codes, but also in tax codes, and the fact that tax assessment is in many countries the most important goal of financial reporting).

Fourth, in contrast to explicit contracts, we expect that implicit contracts could be

⁶ Note however, that whereas in continental European countries, concentrated ownership reduces the conflict of interest problem between owners-managers resulting from the separation of ownership and control, it creates another conflict of interest problem to become important, i.e. conflict of interest between small and large shareholders.

important in creating incentives to manage earnings in continental European countries. The fact that ownership is more concentrated could, for example, create implicit contracts between a firm and its major shareholders, who have often a seat on the board of directors. Kasanen (1996), for example, finds that implicit contracts on dividends with institutional shareholders can be important in creating incentives to manage earnings.

Fifth, a review of the earnings management literature shows that income smoothing may be an important incentive to manage earnings. In general, explanations for income smoothing are job protection, maximization of compensation and avoidance of shareholder interference. These incentives may however be less important in continental Europe, where other incentives are playing a major role. These include tax avoidance, improving terms of trade and pursuing a fixed dividend payout ratio.

Institutional differences may also create different opportunities and constraints on earnings management. First, one can question whether the opportunities to manage earnings are perhaps more limited in continental European countries due to the fact that the law specifies accounting rules in great detail (law-based accountancy) in these countries. In Anglo-Saxon countries the role of judgement is more important (profession-based accountancy) which may leave more room for earnings management.

Second, the opportunities to manage earnings may be different due to differences in ownership structure and corporate governance. Prior Anglo-Saxon research reported that these factors acted as constraints on earnings management. However, the direction of the impact of ownership and corporate governance on earnings management in the continental European setting is not clear. Concentrated ownership and hence closer monitoring by shareholders (see, for example, Burkart et al. 1997, p. 694) can, for example, be hypothesized to constrain the possibility of earnings manipulation. However, the result can also be that firms have less incentives to publish value relevant information to investors, which in turn increases the likelihood of earnings manipulation. Moreover, in continental European countries (some) stakeholders (e.g. large shareholders) have access to internal information so

that they do not have to rely on published financial statements. As a result earnings can be manipulated in order to transfer wealth between them and those users of financial statements (small shareholders and government) who have no access to internal financial information. Therefore, concentrated ownership may no longer function as a constraint on earnings management.

Third, we question whether audit quality may still function as a constraint on earnings management in continental European countries. From Anglo-Saxon studies there is evidence that higher quality (i.e. big6) audits constrain earnings management more than lower (i.e. non big 6) quality audits. Unlike the U.S., stock markets are less developed in continental European countries and auditing is mandatory for companies (even closely held companies) who meet certain legal form and size criteria. A result may be that many firms (especially closely held firms) only demand auditing because it is compulsory and less so for agency or signaling reasons. If this holds to be true, firms will try to fulfill this requirement as cheaply as possible and demand a level of audit quality as low as possible (but that still fulfills the legal requirements). A consequence is that the supply of high quality audits is no longer price competitive in continental European countries and all audit firms (thus also the big6) will supply an equal (low) level of audit quality.

5. Summary

This paper presented (1) a review of the empirical earnings management literature, (2) a discussion of the institutional differences between Anglo-Saxon and continental European countries and (3) a critical assessment of the impact of institutional differences on earnings management.

The empirical earnings management studies examined the incentives for, constraints on and consequences of earnings management. Explicit contracts (such as bonus plans and debt covenants) as well as implicit contracts were found to induce earnings management. Evidence also suggests that earnings are managed (1) to communicate private information to

investors about future firm value, (2) to sell stock for a higher price or (3) to raise additional financing on more favorable terms. Further, the political and regulatory process, and some specific circumstances (such as labor union contract negotiations, proxy contests, and earnings decreases or losses) induce earnings management. The evidence on earnings smoothing is mixed.

There is some evidence that prior accounting decisions, ownership structure, audit committees and internal governance (especially some characteristics of the board of directors) constrain earnings management. Audit quality was found to constrain within GAAP earnings management. Evidence on its impact on non-GAAP earnings management is, however, mixed.

There is conflicting evidence on whether investors can be “fooled” by earnings management in the short run. Even if so, (1) the cost of capital increases or (2) stock performance declines once earnings management is revealed. Also the informativeness of accounting earnings may be reduced.

The review shows that most earnings management studies focus on the Anglo-Saxon institutional environment. However, major differences exist between continental European and Anglo-Saxon countries. Results of Anglo-Saxon studies might therefore not hold in continental Europe. In particular, we argue that earnings management induced by external contracts or a firm’s relation with capital markets may be less important, whereas incentives created by the political and regulatory process and implicit contracts may be especially important. Also income smoothing is claimed to be important in continental Europe, but the incentives may be different. Further, we question whether in continental Europe, a firm’s ownership structure and the quality of its auditor may constrain earnings management. Further research in continental Europe is needed to test these views.

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